

## The Great Recapitalization

On October 14, 2008, the U.S. Treasury announced a voluntary Capital Purchase Program intended to increase the flow of financing to U.S. businesses and consumers. Under the program, the Treasury will inject capital directly into the banking system by purchasing senior preferred equity shares from certain depository financial institutions. Historical precedents exist for these measures, including the bolstering of bank capital with U.S. government funds by the Reconstruction Finance Corporation in the 1930s and the recapitalization of banks by governments in the Nordic countries in the 1990s. This new Treasury recapitalization program is simply the latest policy action of its kind, implemented to respond to recent changes in market perceptions of the risks facing the U.S. banking sector.

During the past several decades, U.S. commercial banks have diversified, continually moving away from their traditional deposit-taking and lending business into lending that is not financed by deposits or by other bank liabilities. Beginning in the 1970s, securitization permitted banks to originate and sell loans, rather than holding loans on their balance sheets. Banks developed new instruments—such as leveraged loans and guarantees on commercial paper—that allowed participation in commercial lending without on-balance-sheet intermediation. This trend was accelerated, to some extent, by the incentive to avoid new regulations and increased capital requirements. The innovations were widely regarded as effectively strengthening the banking system. For example, a 2003 analysis observed that “the improvements in risk management offered by securitization, loan syndication, and hedging via derivatives instruments have helped banks shed unwanted risks.”<sup>1</sup>

Recent financial turmoil has strained bank balance sheets and called into question previous opinion on how securitization would affect bank risk. Many highly lever-

aged loans became unmarketable. Contingent liabilities, such as letters of credit, became burdensome as banks found themselves obliged to bring onto their balance sheets these securities whose market prices were substantially below the original values. House price declines called into question the value of mortgage-based derivatives, while the government conservatorship of Fannie Mae and Freddie Mac, as well as the Lehman Brothers collapse, meant that banks incurred losses on their investments in these institutions. The deteriorating outlook has led financial institutions to become more conservative in their loan-making policies and more prudent overall: Banks are rebuilding their capital at the same time that equity price declines have damaged their capital base. One clear result of the retrenchment of banks and the deterioration of balance sheets is the high spread on interest rates on interbank loans (which have risen) over returns on Treasury securities (which have declined).

This contractionary pressure on banks’ balance sheets, furthermore, comes when considerations about stabilizing the economy justify the expansion of banks’ portfolios at a faster rate. The Treasury’s Capital Purchase Program therefore can be seen from a macroeconomic perspective as a means of arresting the contractionary pressure on the economy. Bank equity capital is a bank liability, as are deposits. Bank equity capital is being boosted by the official recapitalization program, and the safety of deposits has been reinforced by recent legislated increases in deposit insurance. These policy measures shore up the liabilities side of the bank’s balance sheet and, in so doing, encourage expansion of the asset side. These effects help subdue and reverse pressure for financial and economic contraction.

—Edward Nelson

<sup>1</sup> Krainer, John and Lopez, Jose A. “The Current Strength of the U.S. Banking Sector.” Federal Reserve Bank of San Francisco *Economic Letter*, Number 2003-37, December 19, 2003, pp. 1-3; [www.frbsf.org/publications/economics/letter/2003/el2003-37.html](http://www.frbsf.org/publications/economics/letter/2003/el2003-37.html).